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Memorandum

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Subject: Short Period Return

This Chief Counsel Advice responds to your request for assistance dated July 29, 2013.
This advice may not be used or cited as precedent.

LEGEND

Purchaser =

Target =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

x% =

y% =

aa =

bb =

cc =

ISSUE

Whether Target became affiliated with the Purchaser consolidated group as of Date 3, the first day of Year 2 (under Purchaser's theory that the benefits and burdens of ownership of additional Target stock had already transferred from the Sellers of Target to Purchaser and increased Purchaser's ownership of Target to more than 80%), or whether Target was not affiliated with the Purchaser consolidated group until after Purchaser actually acquired the additional Target stock that increased its ownership of Target to at least 80% of the vote and value of Target's stock.

CONCLUSION

Under the relevant purchase agreements, the vote and value of the additional Target shares remained with Sellers until Purchaser actually acquired those shares.

Therefore, Purchaser did not acquire the 80% requisite vote and value of Target until Purchaser purchased those shares and they were released by the escrow agent to Purchaser. Thus, Target was not affiliated with the Purchaser consolidated group until that acquisition and must file a short period return from Date 3 until after Purchaser actually acquired the additional Target stock.

FACTS

Pursuant to a Stock Purchase Agreement ("SPA") executed on Date 1, Purchaser agreed to acquire 100% of the single class of outstanding stock of Target from its shareholders ("Sellers") over the course of several purchases. In Year 1, Purchaser acquired x% (an amount less than 80%) of the Target stock from the Sellers.

Pursuant to section aa of the SPA, Purchaser and the Sellers entered into an escrow agreement ("Escrow Agreement"). Under the Escrow Agreement, all of the Target shares, except for those shares the Purchaser purchased in Year 1, were to be surrendered by the Sellers to a third-party escrow agent. Section aa further provides that

the escrow agent would release to Purchaser any additional shares of Target stock at the time it purchased those shares.

Pursuant to section cc of the SPA, Purchaser could purchase additional shares of Target stock from the Sellers during the first quarter of Year 2. The price of these shares would be determined by a formula based on the value of Target as of Date 2, a date immediately prior to the beginning of Year 2.

Article bb of the Escrow Agreement provides that, until those subsequently purchased shares were released to Purchaser by the escrow agent, the Sellers remained the owners of those shares for all purposes, including, without limitation, tax purposes. Further, during the escrow period, the Sellers retained the right to vote such shares and to receive all dividends and distributions therefrom.

During the first quarter of Year 2, Purchaser purchased these shares and then received them from the escrow agent. As a result of this transaction, Purchaser owned y% (an amount more than 80%) of the Target stock.

LAW AND ANALYSIS

LAW:

Section 1501 states: An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter one for the taxable year in lieu of separate returns.

Section 1504(a)(1) provides that the term “affiliated group” means:

- (A) one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if—
- (B) (i) the common parent owns directly stock meeting the requirements of section 1504(a)(2) in at least one of the other includible corporations, and
- (ii) stock meeting the requirements of section 1504(a)(2) in each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations.

Under Section 1504(a)(2), stock meets the requirements of that provision, if it—

- (A) possesses at least 80 percent of the total voting power of the stock of such corporation, and

(B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

ANALYSIS:

Taxpayer's argument

Purchaser argues that, under the terms of the SPA, it was unconditionally and irrevocably obligated to complete the purchase of a precise number of additional Target shares that would give it exactly y% ownership of Target for a purchase price to be determined on Date 2. Purchaser further argues that courts have established that a sale should be considered closed for tax purposes when there is a binding contract that legally obligates the parties to make the sale and the practical benefits and burdens of ownership have passed to the buyer. See Keith v. Commissioner, 115 T.C. 605 (2000); and Fletcher v. US, 303 F. Supp. 583 (1967 N.D. Ind.), aff'd, 436 F.2d 413 (7th Cir 1971).

Purchaser states that both Target and Purchaser reported the subject sale as closed on Date 3, the first day of Year 2, for tax purposes (as well as for US GAAP financial statement reporting purposes). Purchaser asserts that since it had acquired the benefits and burdens of ownership of those shares of Target stock as of that date, Target was properly included in the Purchaser's consolidated federal tax return group beginning on Date 3. Purchaser asserts generally that this treatment accords with the consolidated return Treasury Regulations, although it does not analyze the specific affiliation requirements of section 1504.

Service position

Under the consolidated return provisions, Target is includible in the Purchaser consolidated group only when Target is affiliated with the Purchaser consolidated group. Sec. 1504(a)(1)(B) and (2). In order to be affiliated, members of the Purchaser consolidated group must own stock of Target that constitutes at least 80% of the vote and 80% of the value of Target, and that ownership must be direct. Id. Because Target has only one class of stock outstanding, that single class of stock contains the sole voting power of Target and the sole value (i.e., the right of those shareholders to receive dividends and liquidating distributions from Target).

As noted above, Purchaser argues that it acquired the benefits and burdens of ownership of the additional shares of Target stock on Date 2. However, the Escrow Agreement provides that Sellers maintained the voting rights and the rights to all distributions on the escrowed stock until the date when those shares were actually paid for and were released to Purchaser. Purchaser has provided no evidence that the parties modified the SPA or the Escrow Agreement or in any other manner shifted to Purchaser the vote and distribution rights on the escrowed stock during the escrow period. Thus, there is no indication that Purchaser held the 80% vote and value in Target – either directly or

indirectly – during the escrow period.¹ Rather, the vote and value requirements were only satisfied after the shares left escrow.

Purchaser appears to argue that the transfer of the benefits and burdens of ownership of these additional shares occurs on Date 2, a date immediately prior to the beginning of Year 2, because, under the SPA, the purchase price for these shares was computed based on the value of Target as of that date. Purchaser further relies on case law that considers the timing of the transfer of beneficial ownership for purposes of determining the holding period for capital assets, and thus for discerning long-term from short-term capital gain. These cases are clearly distinguishable, in that they do not implicate the very specific requirements for affiliation that are contained in section 1504(a), and which control the resolution of the matter currently at hand.

Target does not meet the requirements of section 1504 and is not affiliated with the Purchaser consolidated group until the escrowed Target stock is transferred to Purchaser. Therefore, Target must file a short period return from Date 3 until after Purchaser actually acquired the additional Target stock that increased its ownership of Target to more than 80%.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ if you have any further questions.

¹ In Rev. Rul. 55-458, 1955-2 C.B. 579, the Service held that, where a parent corporation had purchased all of the outstanding stock of another corporation, but the stock was held in escrow as security for the purchase price, the parent corporation could include the other corporation in its consolidated return. By the terms of the agreement executed by the parties, the parent corporation had all the rights of ownership of the stock, including voting and dividend rights, notwithstanding that the stock was held in escrow. Despite the escrow arrangement, the revenue ruling treated the acquiring parent as directly owning the escrowed stock, because of the parent's right to vote the stock and to receive distributions.